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Corporations--Stock Transfer Restrictions--Devolution at Death

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Recent Cases

CORPORATIONS—STOCK TRANSFER RESTRICTIONS—DEVOLUTION AT DEATH

—The bylaws of Taylor Trunk Company, a family corporation, provided: "That no transfer or sale of the stock of the company can be made without first offering said stock for sale to the remaining stockholders at a price of 5% less than the book value of said stock for a period of 60 days upon a pro rata basis of their holdings at the time said offer is made." The entire stock of the company was owned by Guthrie Taylor, Leonard Taylor and Robert Taylor, brothers; the first two held 124 shares each, and Robert Taylor owned 2 shares. Robert Taylor died in 1938, leaving his entire estate to his wife. As the two shares of stock were then pledged to secure a loan, their existence was not discovered until 1953. Guthrie Taylor, as president of the company, declined to transfer the stock registrations to the wife. Leonard Taylor, who had qualified as administrator, and the wife sued to require the corporation to make the transfer. The trial court ruled that under the bylaw provision set out above, the corporation need not transfer the registration until the administrator should have first offered it for sale, one share each to Leonard Taylor and Guthrie Taylor. On appeal, *reversed*: The words "transfer or sale" here apply only to voluntary sales and not to devolution of title by operation of law upon the death of the shareholder. Furthermore, Kentucky Revised Statutes, sec. 395.230 requires that title to a deceased shareholder's stock be transferred to the legatee under a will. *Taylor's Adm'r v. Taylor*, 301 S.W.2d 579 (Ky. 1957).

The instant case deserves special notice for several reasons. The Court dealt with several subsidiary legal points relating to the validity of stock transfer restrictions in Kentucky. In addition, the Court commented upon the effect to be given Section 15 of the Uniform Stock Transfer Act, adopted in Kentucky in 1944,¹ although that provision was held inapplicable to the present case. Inasmuch as this is the first Kentucky case in which the validity of stock transfer restrictions has been expressly delimited, this comment will deal briefly with that general subject before exploring the specific holding.

General Validity of Restrictions on Transfer

Since the transactions in this case arose in 1938, prior to the adoption of Section 15 of the Uniform Stock Transfer Act, the validity of

¹ Ky. Rev. Stat. sec. 274.150 (1956).

stock transfer restrictions had to be determined by reference to the common law.

Transferability of shares is a fundamental characteristic of corporations, and may be regarded as one point of differentiation between corporations and common-law partnerships.² During the early development of corporation law, restrictions upon stock transfers were often held invalid as illegal restraints upon alienation of property,³ or as impairing the remedies of shareholders' creditors.⁴ However, the general proposition that *reasonable* restrictions on transfer are valid is now so well accepted as to be hornbook law,⁵ and the Kentucky Court expressly accepted the general rule in the present case.⁶

There remains a conflict as to the methods which may be used to effect reasonable restrictions. Restrictions authorized by statute,⁷ contained in the charter or articles of incorporation,⁸ or agreed to by the stockholders⁹ are generally upheld. There is more diversity of opinion concerning reasonable restrictions contained in bylaws, but the majority also holds such restrictions valid.¹⁰ The court, in the present case, approved the majority rule but found that the stockholders had, in fact, actually adopted the by-law restriction in question so that it was undoubtedly valid from the standpoint of proper authorization.

In its discussion of Kentucky Revised Statutes, sec. 274.150 (Section 15, Uniform Stock Transfer Act), the court indicated that this provision would, in the future, give validity to any reasonable restriction so long as the restrictive terms appear upon the stock certificate. Section 15 has been adopted in forty-six states, and this interpretation has been given it in all but one of the states which have adopted and interpreted it.¹¹ One court has said that Section 15 merely adds to the pre-existing law of an adopting state¹² the requirement that the restriction appear upon the certificate, and the wording of the statute

² Stevens, Corporations 598 (2d ed. 1949).

³ Victor G. Bloede Co. v. Bloede, 84 Md. 129, 34 Atl. 1127 (1896).

⁴ In re Klaus, 67 Wis. 401, 29 N.W. 582 (1886); Bryon v. Carter, 22 La. Ann. 98 (1870).

⁵ Stevens, Corporations 599 (2d ed. 1949); Ballentine, Corporations 775-76 (Rev. ed. 1946).

⁶ Taylor's Adm'r v. Taylor, 301 S.W. 2d 579, 582 (Ky. 1957).

⁷ For example, Section 15, Uniform Stock Transfer Act.

⁸ 12 Fletcher, Cyclopaedia Corporations sec. 5453 (Perm. ed. 1957 rev. vol.); Stevens, Corporations 600-01 (2d ed. 1949); 13 Am. Jur., Corporations sec. 334, p. 411 (1938).

⁹ 12 Fletcher, Cyclopaedia Corporations sec. 5455 (Perm. ed. 1957 rev. vol.); Stevens, Corporations 601 (2d ed. 1949); 13 Am. Jur., Corporations sec. 336 (1938).

¹⁰ 12 Fletcher, Cyclopaedia Corporations sec. 5455 (Perm. ed. 1957 rev. vol.).

¹¹ Annot., 29 A.L.R. 2d 901 (1953).

¹² First National Bank of Canton v. Shanks, 34 Ohio Op. 359, 73 N.E. 2d 93 (C.P. 1945).

seems to lend itself to such an interpretation.¹³ However, the point seems academic since the Kentucky Court interprets the common law as holding reasonable by-law restrictions valid, at least where the stock is accepted with notice of such restrictions.

The views of the court, as discussed above, appear to be generally in consonance with those of the majority of courts and are mentioned here to draw attention to the case as one of first impression.

The Specific Holding

The court advanced two grounds for its holding. First, the words "transfer or sale" in the bylaw were construed as applying only to voluntary sales and not to devolution of title by operation of law. Second, Kentucky Revised Statutes, sec. 395.230 was construed as overriding the restriction in any application to transfer by death.

In relation to the first point, the court said, "The terms of the by-law . . . seem to be limited to a voluntary sale, although 'transfer' and 'sale' are stated as alternatives. The use of the word 'transfer' looks to a sale and has no natural application to any other disposition."¹⁴

It is difficult to understand why the word "transfer," stated alternatively, means no more than "sale," especially when used ahead of the alternate rather than following it in possible amplification. If either word should receive primary emphasis, it should be the one placed first in order. As to the ordinary legal meaning of "transfer," *Webster's* defines it as "the conveyance of right, title, or property, either real or personal, from one person to another, whether by sale, by gift, or *otherwise*; any act by which the property of one person is vested in another."¹⁵ (*italics added*) The definition given by the *Restatement of Property* is, "The extinguishment of interests existing in one person and the creation of such interests in another person."¹⁶

If any plain meaning is implicit in the bylaw itself, it would seem to be that "transfer" means more than "sale". To say that the word "looks to a sale" is merely to state a conclusion. The words "no transfer or sale . . . *can be made*" (*emphasis added*) do not connote only voluntary, affirmative action, but are conscientiously framed in a passive sense to avoid mentioning action by any particular party. Had the draftsmen intended to prohibit only voluntary sales by shareholders,

¹³ Note that Section 15 is negatively framed, saying ". . . there shall be no restriction upon the transfer of shares . . . unless . . . stated upon the certificate."

¹⁴ *Taylor's Adm'r v. Taylor*, 301 S.W. 2d 579, 583 (Ky. 1957).

¹⁵ *Webster's New International Dictionary* 2689 (2d ed. 1944).

¹⁶ *Restatement, Property* sec. 13(1) (1936).

they could have easily stated that no shareholder might sell his stock, briefly and straightforwardly.

A consideration of the purpose to be accomplished by restrictions of this kind leads to the conclusion that the framers must have intended this restriction to have a wider application than that given it by the court. The purpose behind stock transfer restrictions is usually to enable the stockholders to exclude persons undesirable to them from ownership and control of the corporation.¹⁷ This is widely recognized as a legitimate motive, especially in the case of closely held family corporations.¹⁸ Unless this purpose is completely ignored, it seems impossible to logically exclude transfers by descent from the intended operation of the present restriction. The stockholders are giving themselves insufficient protection from intruders if they may not exercise the buying option ahead of legatees, distributees, and creditors. Who knows who these people may turn out to be? Surely it is illogical to ascribe to the corporation an intent to make such a paradoxical and useless distinction. The court, in its interpretation, is in effect saying that the corporation knowingly defeated its own purpose.

It is the opinion of the writer that the court has gone to unusual lengths to put a strained, unnatural construction upon ordinary words, and in so doing has needlessly thwarted the purpose ordinarily implicit in stock transfer restrictions.

The court did not, however, rest its opinion solely upon this point of interpretation. The second foundation, apparently given even greater weight, involved the application of Kentucky Revised Statutes, sec. 395.230 to stock transfer restrictions. The pertinent parts of this statute are as follows:

In order to effect the distribution of a deceased person's estate . . . the county court may . . . [after provisions for taxes] . . . authorize the personal representative to transfer shares of corporate stock which the decedent owned at his death. . . . Such transfers shall be made *to the persons entitled* under the will or as distributees in case of intestacy. (emphasis added)

This statute was construed as law which gives the shareholder the right to bequeath it [the stock] and his personal representative authority to receive and hold the stock and distribute it to 'the persons entitled under the will.'¹⁹ The court said that this statute provides by necessary implication that the corporation *must* transfer the stock.

¹⁷ Stevens, Corporations 599 (2d ed. 1949).

¹⁸ Succinctly stated endorsements may be found in *Barrett v. King*, 181 Mass. 476, 63 N.E. 934 (1902), by Holmes, J.; *Bloomington v. Bloomington*, 107 Misc. 646, 177 N.Y.S. 873 (1919); and *Casper v. Kalt-Zimmer Mfg. Co.*, 159 Wis. 517, 149 N.W. 754 (1914).

¹⁹ *Taylor's Adm'r v. Taylor*, 301 S.W. 2d 579, 583 (Ky. 1957).

Again, after the court had distinguished a number of cases from other jurisdictions holding that devolution by death did come within stock transfer restrictions, it pointed to the statute as a law not involved in the foreign cases and making "the greater difference."²⁰

The court construed the above statute as requiring a transfer of the stock to the legatee, regardless of what might have been the intended effect of the restriction. If this is the case, then it is impossible, in Kentucky, for a corporation to prevent its stock from coming into the hands of persons adverse to the interests of the corporation where the transfer is effected by will or intestate succession.

The basis upon which the court enunciated this rule is a statute which, by its terms, appears to warrant no such interpretation. The words of the statute are plainly permissive. While the statute says that the county court *may* order distribution, the court has said that such an order *must* be issued. Further, the statute says that under such an order "transfers shall be made *to the persons entitled . . .*" (*italics added*). Even if the issuance of the distribution order were mandatory, it would seem that the question of entitlement would have to be determined before any person could require a transfer. If the restriction were intended to give the remaining stockholders an option to buy, and if, the statute aside, the restriction were valid, the persons entitled could not be determined before exercise or waiver of the option. In this sense, it appears that the statute is brought into play too quickly, and the court begs the question when it assumes that the named legatee is entitled to the stock.

Although no records of legislative debate on this statute have been found, its introductory words, "In order to effect the distribution of a deceased person's estate," suggest to the writer that the legislature thought of the statute as no more than a procedural measure designed to facilitate the settling of estates involving corporate stock.

If the court actually means to say that a stock transfer restriction may never give the corporation a right to purchase its stock ahead of a legatee or distributee, regardless of the language of the restriction and the purpose it intended to accomplish, then this case appears to be the only one of its kind.²¹ The great weight of authority maintains

²⁰ *Id.*, at 584 (Ky. 1957).

²¹ Although restrictions have sometimes been construed as not intended to apply to transfer by death, the writer has found no case holding that a restriction intended to so apply would be invalid. The closest case is perhaps *Stern v. Stern*, 79 U.S. App. D.C. 340, 146 F. 2d 870 (1945). Many cases hold that restrictions may bind a decedent's personal representative: *Allen v. Biltmore Tissue Corp.*, 2 N.Y. 2d 534, 161 N.Y.S. 2d 418, 141 N.E. 2d 812 (1957); *Ky. Package Store, Inc. v. Checani*, 381 Mass. 125, 117 N.E. 2d 139 (1954); *Boston Safe D. & T. Co. v. North Attleborough Chapter*, 330 Mass. 114, 111 N.E. 2d 447 (1953); *Palmer*

that a corporation is justified, in the interests of its stockholders, in seeking to control stock ownership through the option to buy,²² and that restrictions may operate effectively upon transfers by death.²³ In the case of small, closely-held corporations, such restrictions serve a widely approved and sometimes urgent purpose.

If the policy favoring reasonable restrictions may be accepted as valid, the present decision should be closely evaluated and perhaps regarded as distinguishable on future occasions. If the restriction policy is approved, only to have its application defeated whenever an individual shareholder dies, then the interests of corporate ownership groups are needlessly impaired.

Jesse S. Hogg

CRIMINAL PROCEDURE—NARROWING THE DOCTRINE OF THE TRESPASSING OFFICER—State Police officers, dressed in street clothes and driving an unmarked car, drove off a public highway onto the private property of the defendant. Acting on information of bootlegging and on personal observation of an unusual flow of traffic to and from an abandoned service station on the defendant's property, the officers turned into the encircling drive, approached the back door and ordered beer. When the defendant returned from the building with the order, the officers placed him under arrest, seized the beer and proceeded to search the nearby building. The defendant was convicted of the illegal sale of intoxicating liquors, fined and imprisoned.¹ He appealed unsuccessfully to the Rowan Circuit Court, and then to the Court of Appeals, assigning as error the admission into evidence of the beer taken from his person. *Held*: affirmed. 'The officers were not trespassers but were business invitees. They could properly arrest for a misdemeanor committed in their presence and make an incidental search of the defendant's body and seize the beer found thereon. *Staton v. Commonwealth*, 307 S.W. 2d 570 (Ky. 1957).

The court reasoned that the officers making the arrest were customers, not trespassers, regardless of their intent. The court cited no authority, but distinguished *Alfred v. Commonwealth*,² the principal case relied on by the defendant. In that case the court held that when

v. Chamberlain, 191 F. 2d 532 (1951), Misc. 68 N.Y.S. 2d 335 (1946); *Searles v. Bar Harbor Banking & Trust Co.*, 128 Me. 34, 145 Atl. 391 (1929).

²² 12 Fletcher, *Cyclopedia Corporations* sec. 5454, at 306 (Perm ed. 1957 rev. vol.).

²³ *Ibid.*

¹ See Ky. Rev. Stat. sec. 242.230(1) (1956).

² 272 S.W. 2d 44 (Ky. 1954).